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Chief, Finance Branch

4 March 1944

Legal Division

Taxability of Cost-of-Living Allowances paid to Employees Residing Abroad

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Reference is made to your memorandum of 19 February 1944 with attached letter from Mr. [ ] and mimeographed circular of the Office of Economic Warfare, both of which are returned herewith.

Section 125 of the Revenue Act of 1943 (enacted 25 February 1944 over Presidential Veto) reads as follows:

"SEC. 125. EXCLUSION FROM GROSS INCOME OF CERTAIN  
COST-OF-LIVING ALLOWANCES PAID TO  
CIVILIAN OFFICERS AND EMPLOYEES OF  
THE GOVERNMENT STATIONED OUTSIDE  
CONTINENTAL UNITED STATES.

"(a) IN GENERAL.—Section 116 (relating to exclusions from gross income) is amended by adding at the end thereof a new subsection to read as follows:

"(j) In the case of a clerk or employee in the Foreign Service of the United States, amounts received as cost-of-living allowances under authority of section 3, as amended, of the Act of February 23, 1931; and in the case of an ambassador, minister, diplomatic, consular, or Foreign Service officer, amounts received as post allowances under the authority of section 12, as amended and renumbered, of the Act of May 24, 1924; and in the case of other civilian officers or employees of the Government of the United States stationed outside continental United States, amounts received as cost-of-living allowances in accordance with regulations approved by the President."

"(b) TAXABLE YEARS TO WHICH APPLICABLE.—The amendment made by subsection (a) shall be applicable with respect to taxable years beginning after December 31, 1942."

Cost-of-living allowances paid in accordance with regulations approved by the President on 30 December 1942, or subsequent regulations, hence are to be excluded from gross income for the calendar

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year commencing 1 January 1943, or any fiscal year commencing subsequent to that date.

In the memorandum of 6 September 1943 from this office to you it was pointed out that cost-of-living allowances were includable as gross income, and no portion of the actual expenses could be deducted in computing net income. In the case of employees of some government agencies (e. g., officers and employees in the Foreign Service of the State Department, employees of the Foreign Commerce Service, Bureau of Foreign and Domestic Commerce, Treasury attaches, employees in the Customs Agency Service, and OEW employees), the Treasury Department had previously ruled that that portion of the allowance attributable to living quarters could be deducted (See XII-2 [1935] C. B. 30; XIV-1 [1935] C. B. 44, 45). These rulings were based upon the theory that the nature of the employee's duties required that he have appropriate living quarters of convenient location, as he would frequently be called upon to transact business in them. The rulings are in harmony with the general rule that the cost of meals and lodging will not be included in the gross income of an employee if they are furnished for the convenience of the employer and the employee is required to receive them properly to perform his duties (See 1940-1 C. B. 14). In the case of employees of other government agencies, the Bureau of Internal Revenue has felt that the cost-of-living allowances were compensatory in nature and were paid in their entirety for the benefit of the individual employee (and not for the benefit of the United States) and hence were required to be reported as income.

The question has been finally resolved by Section 125 of the Revenue Act of 1943, quoted above, and no portion of the cost-of-living allowances need be reported as income by the recipient. You will note that the ruling by the Commissioner of Internal Revenue in the case of OEW employees relates only to 40 per cent of the total allowance which was taken to be applicable to the cost of quarters. Under the new act, the total allowance is excluded from gross income.

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cc: Cal.

- Maj. Lee

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